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Carl Icahn and Bob Farrell

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL Financial contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

Prior to his retirement some years ago, Merrill Lynch's chief market strategist Bob Farrell held a lot of sway over the market. He had a great perch to observe its technical condition and psychology at one of the largest global brokerage firms. Among his lasting contributions to the business are ten market rules that remain widely quoted today. Value investors invest based upon his first rule: markets tend to return to the mean over time.

Farrell's rule number nine states that when all the experts and forecasts agree, something else is going to happen. For banks the rule may apply to the narrative that once the Fed begins to raise short rates net interest margins will begin to rise, which in turn will drive EPS and share prices higher. What might be the alternative? The Fed does not raise short rates, NIM expansion is preempted by deposit and loan competition, or the script works but the stocks do not because estimates reflect hikes or credit concerns emerge. Comerica Inc., one of the more asset sensitive regional banks, drew attention to credit in an era of very low provision expense by surprising the Street with a jump in provision expense for its energy book. Its shares fell 6% on the day of the announcement even though incremental reserve building should not have been a surprise because oil prices collapsed last year.

Several rules came to my mind when Carl Icahn and BlackRock Inc. CEO Larry Fink had a confrontation over the role of BlackRock, ETFs and bond market liquidity at a conference on July 15. Icahn echoed rule number five that the public buys the most at the top and the least at the bottom when he offered that financial advisors are plying uninformed retail investors into ETFs that invest in high yield bonds. Whenever concerns about a turn in the business cycle and rising defaults come, investors may dump the ETFs and exacerbate pressure on the underlying bonds, which are illiquid and have less market stabilization support from banks today as a result of the Volcker Rule. Or per rule number six, fear and greed are stronger than long-term resolve.

Icahn went on to describe the current market as a party bus that is being pushed by Fink and Fed Chair Janet Yellen that is headed for a cliff. He then answered his rhetorical question of what would the bus hit when it fell?—"a black rock." Carl Icahn has never sought to charm Wall Street, but he knows how to make money, which is the only thing the Street really cares about. He said that he is speaking up now because he had the same concerns before the financial crisis but did not publicly voice them enough.

Perhaps Icahn was talking his book or a book that he wants to build if prices were not so high. If so, rule number two applies: excesses in one direction will lead to excesses in the other direction. And so would rule number three (there are no new eras because excesses are never permanent) and four (markets rarely correct by going sideways) apply.

Are market prices excessive today? I think the answer is yes with regard to the corporate bond market and probably so for many commercial banks. That is just an opinion, however. The Fed will be the final arbiter. Zero interest-rate policy or near ZIRP forever may mean a bond rated BB that has a five -handle yield really is a good investment as long as the issuer can cover the coupon and refinance the debt at or before maturity.

In fairness to Fink, I think he and other BlackRock executives have been arguing that the Fed needs to move and that ETFs have brought (some) liquidity to a fundamentally illiquid market. Because of ZIRP, investors have to move out the risk curve for income. BlackRock and others have supplied an easily tradable product that provides it. Liquidity is a very good thing for markets, though not necessarily for value investors.

I think Icahn is right that retail and maybe some institutional investors have no idea what they own other than an income producing asset whose price has been steady or rising over the past several years. Liquidity has a way of appearing when it is not needed and evaporating when it is needed most. Icahn made good money on CIT Group Inc. in 2009 when the company had a liquidity crisis by investing in the company's debt and then supporting the company through bankruptcy reorganization.

Does price risk matter? Years ago I heard the phrases "price-cures-price" and "there are no bad bonds, only bad bond prices." Icahn may be right that there potentially is a brewing disaster because easy Fed liquidity has pumped up asset prices that eventually will revert to the mean; however, he probably will be well positioned to profit. Value attracts liquidity, though a different type of liquidity than exists today that is exemplified by rule number ten that states bull markets are more fun than bear markets.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.